



Clark County, Washington

**Investment Management Review
Third Quarter 2001**

Public Financial Management, Inc.
One Keystone Plaza, Suite 300
North Front & Market Streets
Harrisburg, PA 17101-2044
(717) 232-2723
fax (717) 233-6073



In spite of significant monetary and fiscal stimulus in the form of Federal Reserve rate cuts and tax rebate checks, the economy continues to sputter and has shown little signs of improvement. The tragic events of September 11th paralyzed the country with grief and horror. Compounded by a growing concern about layoffs, consumer sentiment and spending have been severely dampened. Consumers, who account for two-thirds of the economy, were the last major segment of the economy that was unaffected by the current economic slowdown that has plagued the manufacturing sector for nearly a year. These factors have raised concerns that the U.S. economy is in a prolonged period of weakness.

The County pool portfolio had a par value of \$450 million as of September 30, 2001, a slight increase from the previous quarter's \$427 million. The portfolio was slightly restructured shifting away from Certificate of Deposits into the Washington State Local Government Investment Pool. The Pool portfolio remained well diversified by sector and maintained a high overall credit quality, liquidity, and exposure to call/reinvestment risk. A summary of third quarter highlights and PFM's recommendations follow.

- **Asset Diversification** – The asset allocation of the portfolio changed only slightly quarter-over-quarter. The allocation to Money Market Accounts increased by a modest 8.7 percentage points. This shift in emphasis came as a result of less exposure to Certificate of Deposits and Commercial Paper.

Sector Composition Comparison				
	9/30/00	6/30/01	9/30/01	Quarter Change
Certificates of Deposit	1.6%	9.4%	4.4%	(4.9%)
Commercial Paper	12.0%	4.7%	2.2%	(2.5%)
Federal Agency Discount Notes	3.9%	7.0%	8.9%	1.9%
Federal Agency Notes	56.3%	57.3%	54.4%	(2.9%)
Treasury Securities	7.8%	4.7%	4.4%	(0.2%)
Municipal Obligations	1.3%	1.2%	1.1%	(0.1%)
Passbook/Money Market Accts	17.0%	15.8%	24.5%	8.7%
Totals	100%	100%	100%	

*Based on par values of securities in pool portfolio.

- **Maturity Distribution** – The County's pool portfolio maintained an average maturity of 9.8 months during the quarter. PFM's suggested maturity target for the County's portfolio continues to be 9-10 months. Therefore, our recommendations in this report include suggestions to maintain the duration.
- **Credit Quality** – The County maintained the portfolio's low exposure to credit risk. As of the end of the quarter, 72% of the portfolio was invested in securities rated "AAA" (highest long-term rating) or "A-1 / P-1" (highest short-term rating). 24% of the portfolio was invested in un-rate State LGIP.
- **Liquidity** – As of September 30, 94% of portfolio assets were categorized in one of PFM's top four liquidity rating categories (1, 2, 3, and 4). The overall weighted liquidity factor was 2.86 well within PFM's recommended range of 2 to 4.
- **Market Risk** – The Pool remains principally invested in securities maturing under 2-years as of September 30, classifying 88% of the portfolio in the low to low/average categories of market risk.
- **Callable Exposure** – The total portfolio exposure to call risk inched lower to 13% due to the increase in portfolio size. This allocation is in line with PFM's maximum recommended limit of 20% to 25%.

As described in more detail in the accompanying report, the investment strategy employed by the County Pool appears to be prudent and appropriate given the County's historic cash flow patterns and current market conditions.



Third Quarter 2001 Economic Summary

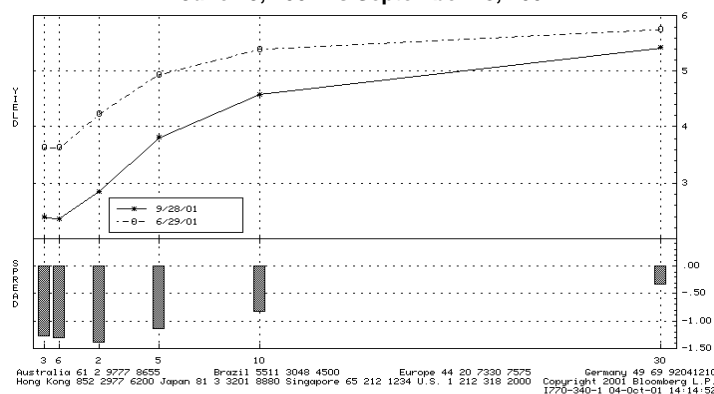
Earlier this year, Alan Greenspan outlined two possible paths for the future of the economy. The first path was a V-shaped rebound as inventory liquidation concluded and the economy resumed its pace of growth. The second path was a more prolonged period of weakness occurring if economic uncertainties breached “the fabric of confidence” among consumers. While everyone hoped the economy would take the first path, it appears the economy has started down the second path. Despite aggressive easing in monetary policy, in which the target Federal Funds Rate was lowered 8 times from 6.50% to 3.00% by the end of the third quarter; continued economic weakness, sagging stock prices and a dramatic number of layoffs have begun to significantly affect consumer sentiment. Conference Board Consumer Confidence crumbled in September, joining the already weak manufacturing and employment indices. In addition, fears that the terrorist attacks on New York City and Washington D.C. will result in curtailed spending, caused the bond markets to surge with prices sharply increasing and yields falling dramatically. The yield on the 2-year Treasury Note fell by 139 basis points (1.39%) during the quarter bringing it to 2.85%, a low not seen since the Eisenhower Administration, 43-years ago. Deteriorating economic conditions and repercussions from the September 11th terrorist attacks prompted the Federal Reserve to lower the federal funds rate by an additional 50 basis points in early October, while keeping open the possibility for further rate cuts this year. The target federal funds rate now stands at 2.50%, the lowest level in 39 years.

2 Year U.S. Treasury Yield History
January 1, 1995 - September 28, 2001



Interest rates across the yield curve were driven lower as the markets anticipated a prolonged period of little or no growth and benign inflation. During the quarter, the yield on the 3-month Treasury Bill and 6-month Treasury Bill fell by 129 basis points (1.29%) to a yield of 2.37% and 2.35%, respectively. Unlike prior quarters the yield on longer-term securities also declined sharply, signaling the market's belief that a near term economic recovery is unlikely. The yield on the 5-year Treasury Note fell by 115 basis points (1.15%) to a yield of 3.80%. The 10-year Treasury Note fell from 5.41% to 4.59%, an 82 basis point decline; while the 30-Year Bond fell by 34 basis points (0.34%) to 5.42%. This sharp shift in

U.S. Treasury Yield Curve
June 29, 2001 vs September 28, 2001



the yield curve resulted in a steeper, more positively sloped curve, which in turn led to unusually high returns for the quarter. For example, the Merrill Lynch 1-3 Year Treasury Index ended the quarter with a return of 14.77%. Intermediate-term securities returned the greatest quarterly total returns since the fourth quarter 1991, with outstanding performance by the longer, intermediate-term portfolios.

Spreads between Federal Agencies and U.S. Treasuries were somewhat volatile

in the quarter as the tragic events of September 11th resulted in an immediate “flight to quality,” which



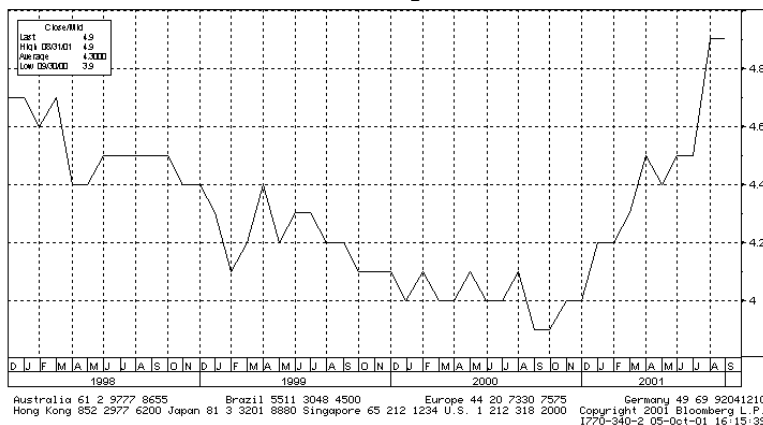
considerably widened the spreads between these sectors. By the end of the quarter, spreads returned to levels seen earlier in the quarter resulting in Federal Agencies performing slightly better than comparable maturity Treasuries. In general, high-quality 'AA' and 'AAA' corporate securities outperformed both Agencies and Treasuries as yield spreads narrowed slightly. Although 'A' rated corporate issues returned an impressive annualized return of 14.35% during the quarter, similar maturity Agencies outperformed this sector. In the current economic slowdown, corporate downgrades continue to outpace upgrades by a wide margin putting a premium on careful credit selection.

Economic data released during the third quarter supported a growing pessimistic view on the state of the economy. The equity markets quickly responded to this wave of negative economic data sending the major indices to new 3-year lows. The Dow Jones Industrial Average fell 15.8%, the broader Standard & Poor's 500 Index dropped 15.1% and the volatile NASDAQ Composite slumped 30.6% throughout the quarter.

Recently released economic data shows deteriorating conditions, including, most notably consumer confidence.

EMPLOYMENT The dramatic number of layoffs announced earlier this year continued to take their toll on employment. Non-farm payrolls declined sharply in September with 199,000 jobs lost. For the 3rd

**Unemployment Rate
December 1997 – September 2001**



quarter, the economy lost a total of 265,000 jobs—the second consecutive quarterly decline in non-farm payrolls. Initial jobless claims have climbed higher due to layoffs in industries affected by reduced tourism, particularly airlines, hotels, and vacation resorts. For the week ended September 29, initial jobless claims were 528,000; the highest level since July 1992. The broader unemployment rate showed a modest rise during the quarter from 4.5% to 4.9%.

CONSUMER CONFIDENCE After consumer confidence seemingly

stabilized through the first half of 2001, Conference Board Consumer Confidence plunged sharply lower at the end of the quarter. Consumer Confidence declined to a level of 97.6, sharply off the 118.9 reading at the end of the 2nd quarter. This 16.4 point decline in September represents the largest monthly decline since October 1990 and the lowest level for the index since January 1996. Continued weakening in the labor markets have weighed heavily on consumers' view of the jobs markets. The percentage of consumers viewing jobs as "hard to get" has accelerated, reaching 18.5% in September. Market observers point out that consumer confidence is likely to fall even further in the coming months given the exacerbated economic weakness and uncertainty regarding the future.

MANUFACTURING ACTIVITY The economy lost 308,000 manufacturing jobs in the quarter, including 93,000 in September, but the National Association of Purchasing Managers (NAPM) Index, a measure of manufacturing activity, unexpectedly spiked higher in August to a level of 47.9%. Although the NAPM Index fell slightly in September, this index has shown significant improvement since June and seems to indicate some stabilization in the manufacturing sector after nearly a year of weakness. While a



reading below 50% is still indicative of contraction in the manufacturing sector, the apparent stabilization is a spark of good news amidst the recent deterioration of other indicators.

GROSS DOMESTIC PRODUCT (GDP) GDP for the second quarter rose only 0.3% (annualized growth). Corporate profits fell 14.9% over the last four quarters, the largest year-over-year decline since the 1980-1981 recession, after reaching historical levels in 2000. As a result of the decline in consumer spending, most economists predict real GDP could show negative growth for the 3rd quarter. In their statement from the October 2nd meeting, the Federal Open Market Committee reiterated their belief that “the risks are weighted mainly towards conditions that may generate economic weakness in the foreseeable future.”

ENERGY PRICES After the terrorist attacks on September 11, crude oil prices spiked from \$27 to \$30 in anticipation of military uncertainties in the Middle East. Within a week, prices fell nearly \$8 a barrel as airlines across the United States were grounded and forecasted a sharp reduction in air travel for the next several months.

HOUSING ACTIVITY The housing sector remains one of the only sectors not significantly impacted by the economic slowdown. Existing home sales were stronger than expected in August rising 5.8% to 5.5 million units. Economists are predicting the housing sector to hold up fairly well as individuals take advantage of lower long-term rates to refinance their mortgages.



Sector Distribution

The table below compares the portfolio composition of the County pool for the past two quarters and one year ago. The County took advantage of higher yields offered by money market accounts, such as the Washington State Local Government Investment Pool, in a declining rate environment by increasing the allocation to this sector from 15.8% to 24.5%. As of September 30, 2001, the County pool maintained a balance of approximately \$110 million in passbook/money market funds. This was an increase of about \$43 million since June 30, 2001.

As a consequence of this emphasis, the allocation to several other short-term money market sectors was reduced minimally. The most notable change was the allocation to Certificate of Deposits, which declined from 9.4% to 4.4% of the portfolio. This was due to the maturity of \$20 million in Certificate of Deposits that were purchased in late April/early May at substantially higher rates than current interest rates. As of September 30, 2001, the portfolio remains well diversified.

Sector Composition Comparison				
	9/30/00	6/30/01	9/30/01	Quarter Change
Certificates of Deposit	1.6%	9.4%	4.4%	(4.9%)
Commercial Paper	12.0%	4.7%	2.2%	(2.5%)
Federal Agency Discount Notes	3.9%	7.0%	8.9%	1.9%
Federal Agency Notes	56.3%	57.3%	54.4%	(2.9%)
Treasury Securities	7.8%	4.7%	4.4%	(0.2%)
Municipal Obligations	1.3%	1.2%	1.1%	(0.1%)
Passbook/Money Market Accts	17.0%	15.8%	24.5%	8.7%
Totals	100%	100%	100%	

*Based on par values of securities in pool portfolio.

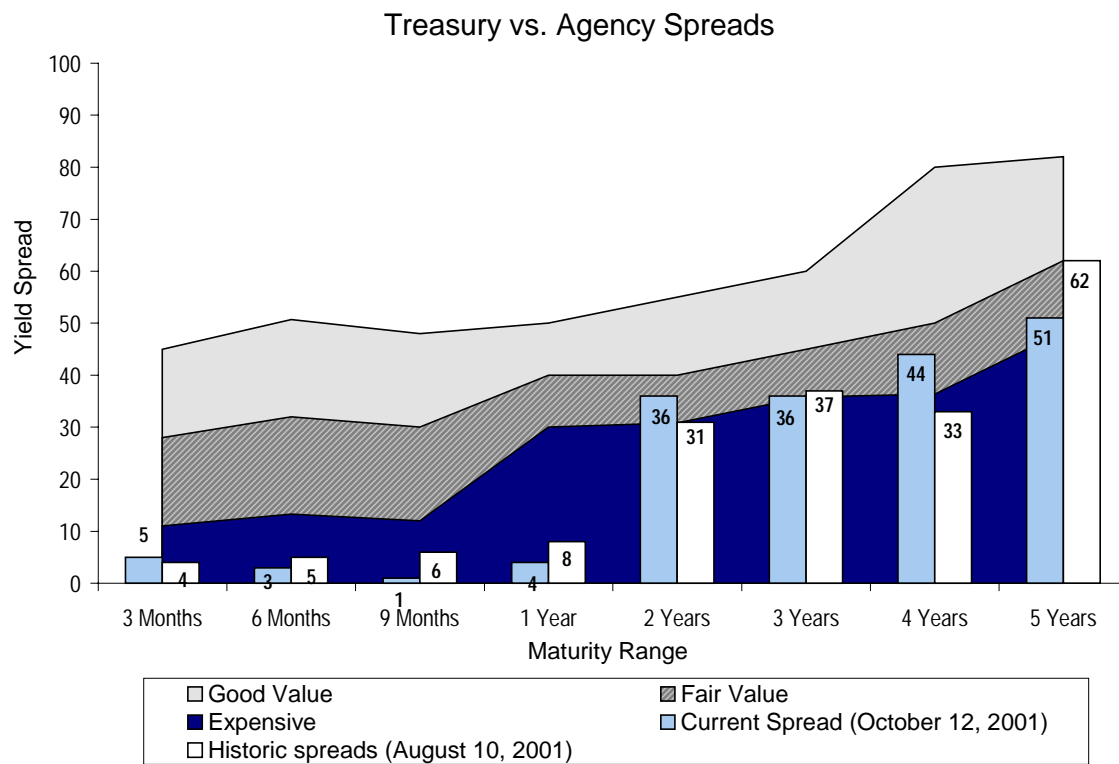
As the Federal Reserve cuts short-term rates to help stabilize consumer confidence and stimulate a contracting economy, money market accounts offer higher yields than alternative market sectors. At the end of September, the Washington State LGIP reported a distribution rate of 3.58% - well above the rate on short-term investment options. We recommend that the County continue to invest short-term funds in the State Pool since the Fed's rate cuts in September and October have not been fully reflected in the yields of the LGIP. An over weighting of assets in the State LGIP will continue to make sense as long as the Pool pays a rate above the prevailing market rate.

We would also recommend that the County begin looking for opportunities related to year-end funding pressures. Due to the increased volatility of the markets, issuers may look to get year-end funding completed earlier this year and may present an excellent opportunity to lock-in short-term securities at higher yields.



Immediately following the terrorist attacks on September 11th, spreads between Federal Agency securities and U.S. Treasuries widened significantly in a “flight to safety” which would be expected in the magnitude of the attack and the uncertainty it created. It is typical that following an unexpected political or economic event, investors aggressively purchase securities with the greatest safety and liquidity in the market. This “flight to safety” lasted for about two weeks and spreads between these sectors have returned to levels seen before this national tragedy.

As depicted below spreads between U.S. Treasuries and Federal Agencies are quite narrow, especially on securities that mature within one year. We continue to recommend that the County monitor the performance of U.S. Treasuries relative to Federal Agencies and *possibly* increase the portfolio’s allocation to the Treasury sector if Treasuries maintain this strong relative value.





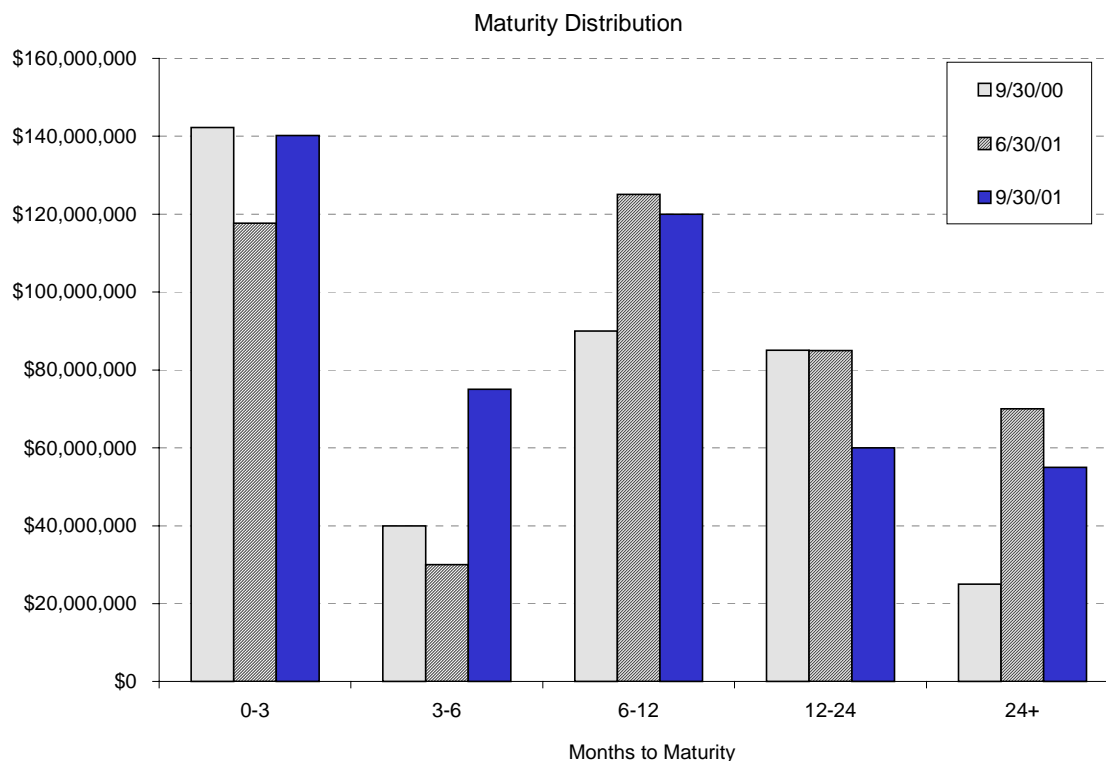
Maturity Distribution

As of September 30, the portfolio remained liquid with 31% of the Pool's holdings maturing within 3 months. During the third quarter, the average maturity decreased from 12.3 months (370 days) on June 30, 2001, to 9.8 months (294 days). This shortening of the portfolio was the result of the passage of time. The County's investment of approximately \$100 million in Federal Agency Notes maturing between March 2002 and May 2004 during the 2nd quarter proved to be quite opportune as rates on intermediate securities fell throughout the quarter.

The current average maturity of the Pool is within PFM's suggested average target maturity of 9 to 10 months. As previously mentioned in the PFM's Second Quarter Investment Management Review, portfolios that have a number of callable securities should be analyzed based upon average maturity and also by the concept of effective duration. Effective duration is a measure of the actual price sensitivity of the security given current market rates and recognizes the changing value of the imbedded call options. As of September 30, 2001, the effective duration of the County Pool was 0.72 years or 8.6 months. This compares with an effective duration of 0.81 years or 9.7 months as of June 30, 2001.

Looking forward, we recommend that the County maintain an average weighted maturity in the 9 to 10 month range or an effective duration of roughly 9 months. To maintain this target range, PFM recommends a portion of funds allocated to money market accounts be invested in short-term obligations if year-end funding pressures materialize. In addition, the County could invest in Federal Agency obligations with maturities between 2 and 3 years.

The chart below illustrates the maturity distribution of the County's portfolio as of September 30, 2001, the prior quarter end, and the distribution a full year ago.

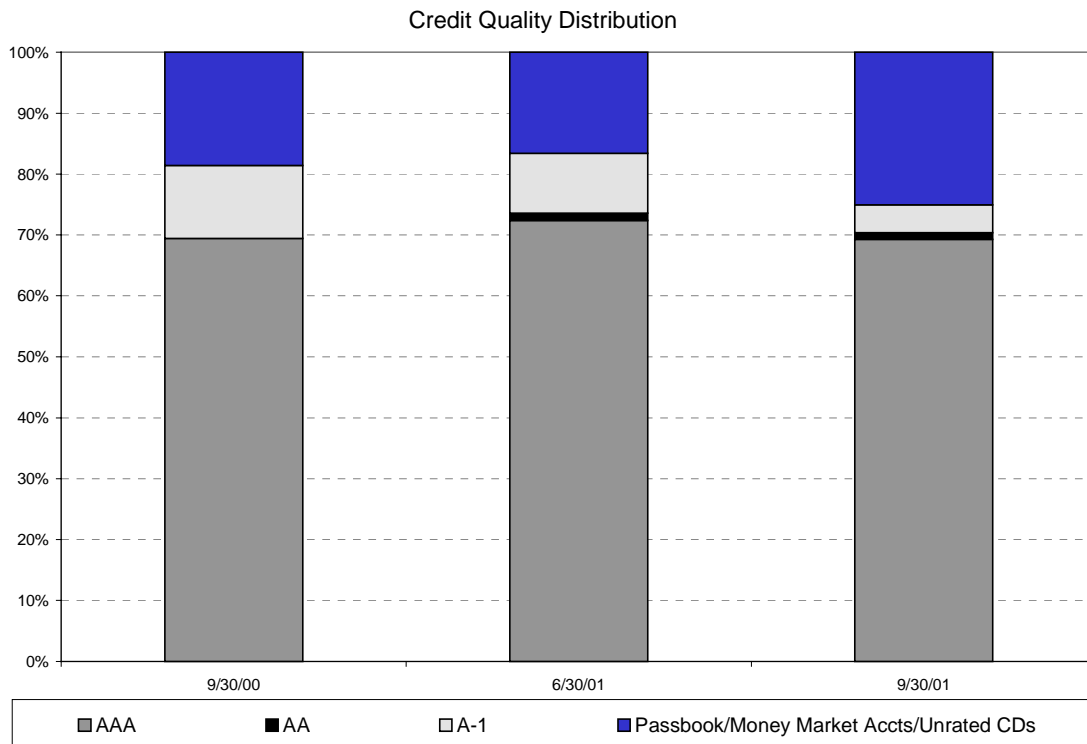




Credit Quality

As of September 30, 2001, 72% of the portfolio was invested in obligations rated “AAA” or “A-1/P-1”, compared to 78% invested in “AAA” and “A-1/P-1” as of June 30. The overall high credit quality of the portfolio continues to be maintained by the County’s investment strategy.

The chart below shows the credit quality distribution of the portfolio as of September 30, 2001, compared to June 30, 2001, and September 30, 2000.



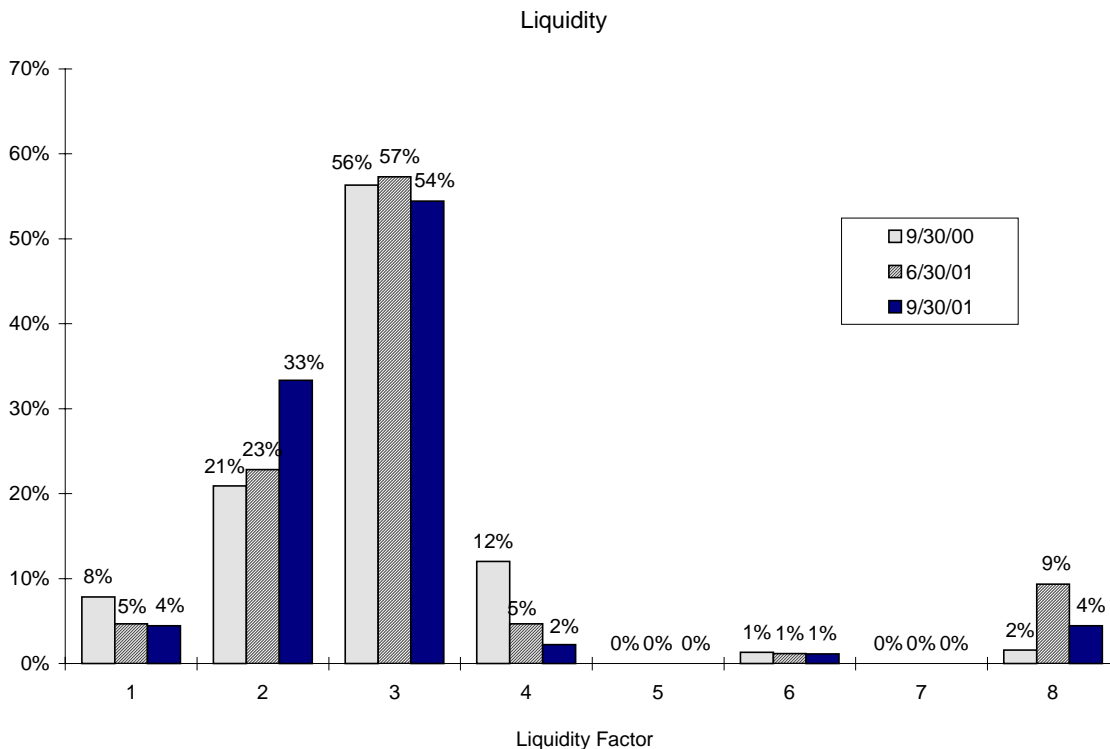


Liquidity

The County's portfolio remains highly liquid. As of September 30, 2001, 94% of the portfolio was invested in obligations rated among one of PFM's four highest liquidity-rating categories (1, 2, 3, and 4), with the remaining 6% invested in non-negotiable certificates of deposit and municipal obligations.

During the quarter, the average-weighted liquidity of the portfolio decreased modestly from 3.23 as of June 30, 2001, to 2.86 as of September 30, 2001. This increase in the liquidity of the portfolio was the result of the maturity of \$20 million of certificates of deposits. The portfolio remains well within PFM's recommended liquidity range of 2 to 4.

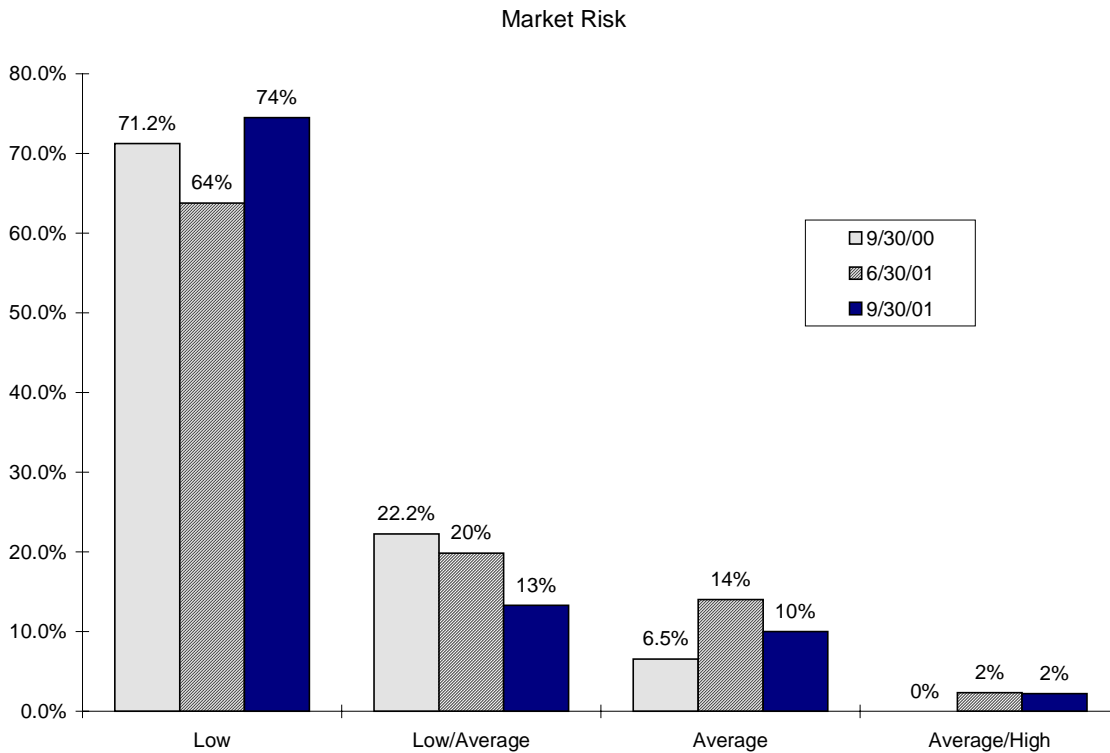
The chart below shows the liquidity distribution of the portfolio as of September 30, 2001, compared to June 30, 2001, and September 30, 2000. Category 1 represents securities that can be easily sold with little difference between the bid and offer prices, such as U.S. Treasuries. Category 8 represents securities that are generally considered illiquid such as non-negotiable certificates of deposit.





Market Risk

Approximately 74% of the portfolio is invested in securities with maturity dates less than 365 days. These holdings are classified as having a low exposure to market risk. Nearly 88% of the portfolio was invested in securities with maturities under 2 years and can be categorized as maintaining a low or low/average exposure to market risk. \$55 million par was invested in securities that matured beyond two years at the end of the quarter. The chart below shows the portfolio's exposure to market risk as of the current quarter end, 3 months ago, and one year ago.



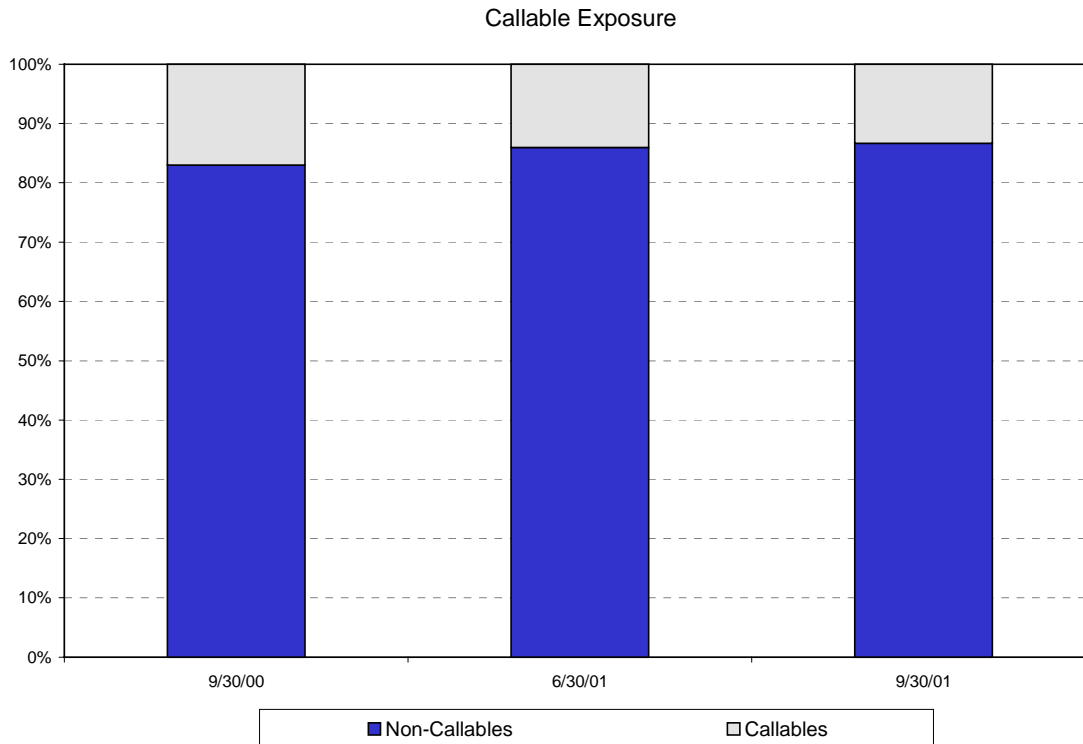
Securities in the portfolio are shown to their ultimate maturity date. Because a number of the longer-term holdings are callable, it is possible that they will be called prior to maturity. Therefore, this analysis may slightly overstate the market risk in the portfolio.



Call Exposure

The portfolio's allocation to callable obligations remained unchanged with \$60 million in callable Federal Agencies held by the Pool as of September 30, 2001. This represented approximately 13% of the total funds invested by the Pool. This is well within PFM's recommended maximum of 20-25% allocation in callable securities.

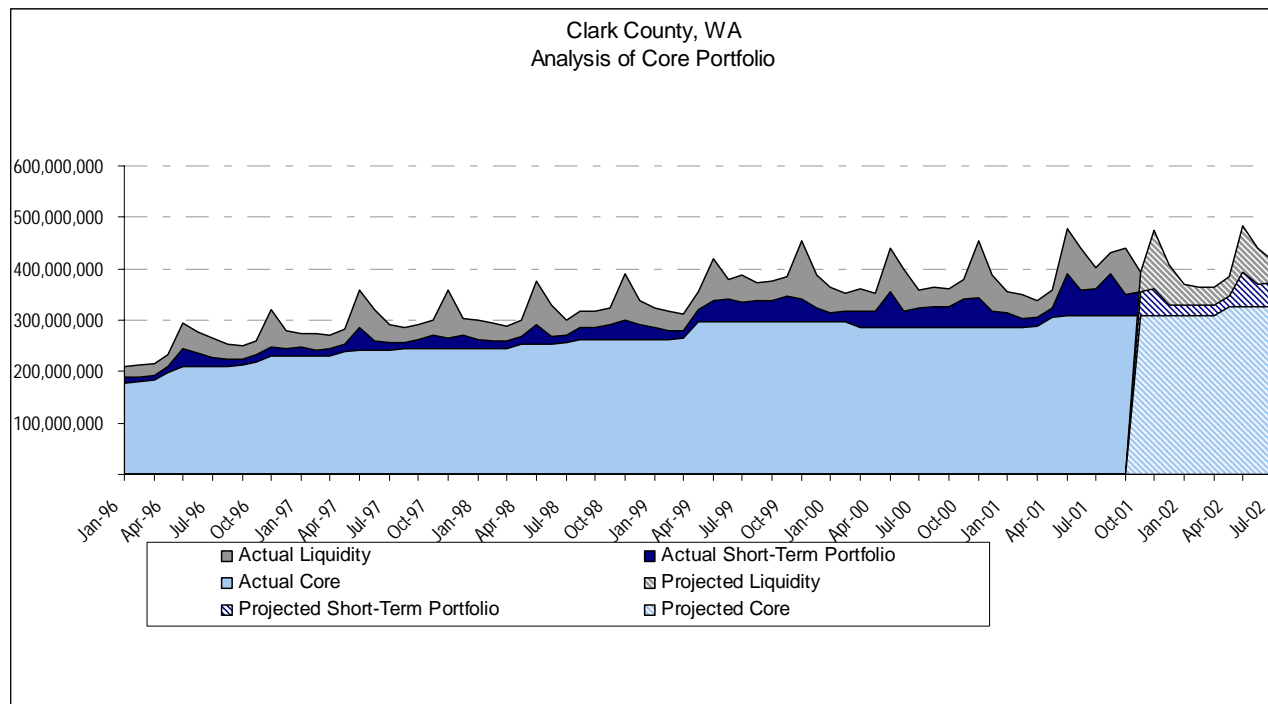
These callable securities were all purchased with nearly a year of call protection with the first call of these securities occurring between February and May 2002.





The chart below represents cash flow projections for the County's portfolio. The model is based on changes in historic balances from January 1996 to September 2001. The data on the left side of the chart represents actual historical data. The data on the right side represents projected balances. Projections are based on historical seasonality¹ and a 5% annual growth rate.

The portfolio is allocated among the following three components: 1) Liquidity – representing funds needed to cover cash needs in the upcoming month. These funds are typically invested in very short-term money market instruments and the State LGIP. 2) Short-term portfolio – this includes funds set aside to provide liquidity for anticipated disbursements in two to six months and an added cushion should liquidity requirements suddenly increase. And 3) Core – this represents the portion of the portfolio that can be invested in longer-term obligations to achieve higher rates of return over the long run.



As reflected by the chart, the County's portfolio balance predictably reaches its peaks in May and November and its low points in March and September. The results of this analysis suggest that the portfolio will experience a sizeable net cash inflow in November with a modest \$70 million decline from November to December.

¹ A predictable change in the monthly balance from year-to-year due to the timing of cash inflows and outflows.



The following table focuses on the relative value of shorter-term investments between sectors. The table illustrates the current yield spreads and the 6-month average spreads of various securities as compared to U.S. Treasury Bills in the same maturity range. The table also provides an evaluation and current outlook of PFM portfolio managers on the short-term market. Since the County needs to maintain a relatively high degree of liquidity in its portfolio, this may serve as an additional reference for evaluating trade opportunities in the current market.

REVIEW OF INVESTMENT SECTORS										
10/15/01	Sector Spreads to U.S. Treasuries								Current Evaluation	Recommendation & Outlook
	60-90 days		120-180 days		180-270 days		270-360 days			
		6 mo. Avg.		6 mo. Avg.		6 mo. Avg.		6 mo. Avg.		
<u>Sector</u> US Treasury Bills	2.25%		2.23%		2.22%		2.35%			
Agency Discount Notes	0.05%	0.16%	0.03%	0.15%	0.01%	0.10%	0.04%	0.08%	FAIR HOLD OR BUY	D/N spreads have come in, are trading in line with BA's.
Non-callable	0.07%	0.18%	0.06%	0.17%	0.08%	0.13%	0.03%	0.10%	FAIR HOLD OR BUY	Federal Agency Notes are in line with Agency D/N, sporadic supply.
Callable (1yr/3month)							0.12%	0.14%	FAIR HOLD	New issue callable securities have recently been issued, but are fairly scarce.
Bankers Acceptances	0.06%	0.19%	0.04%	0.16%	0.06%				FAIR HOLD OR BUY	BA's are in line with discount notes, limited supply.
Commercial paper	0.08%	0.19%	0.07%	0.18%	0.06%	0.14%			CHEAP HOLD OR BUY	CP is in-line with CD's, offer the best value throughout the curve.
Repurchase Agreements (Term)	0.16%		0.13%						FAIR – CHEAP HOLD	REPO offers some value short-term, O/N-1 week vs. Agency D/N's.

The Federal Reserve lowered the Federal Funds Rate by an additional 50 basis points on September 17th and October 2nd. These moves marked the eighth and ninth times the FOMC lowered interest rates this year and brings the target Federal Fund rate to 2.50%.

In this environment, the State LGIP offers good value along with excellent liquidity. (Typically when interest rates drop swiftly, as they did throughout this year, money markets accounts, such as the LGIP, “lag” the market by offering a higher yield than can be obtained on the open market.) We feel that the State LGIP will likely offer the best relative value in the coming weeks. However, we still recommend that the County evaluate alternative investment sectors, such as high-quality (A-1) commercial paper and collateralized certificates of deposit, against the LGIP.



Provided below is a summary of PFM's recommendations.

- **Maintain allocation to Federal Agency obligations.** Yields on short-term maturities have continued to fall. The yield spreads between U.S. Treasuries and Federal Agencies have narrowed for short and intermediate maturities. With only a limited number (\$5 million) of Federal Agencies maturing before January, we recommend that the County maintain the current sector allocation.
- **Maintain allocation to the State LGIP.** Yields on money market funds, such as the State LGIP, tend to lag the market. Evaluate alternative investment sectors against the Washington State Local Government Investment Pool. If the LGIP offers a higher yield, we would suggest maintaining or possibly increasing the allocation to the LGIP to enhance returns. This liquidity would offer additional flexibility in securing higher rates due to potential year-end funding pressures.
- **Maintain the portfolio's average maturity of 9-10 months.** The average portfolio maturity modestly decreased to 9.8 months during the quarter. This is within PFM's recommended maturity range of 9-10 months. In order for the County to maintain this target maturity range, the County may want to invest a portion of the \$35 million in maturities out longer-term or perform extension trades within the portfolio, particularly if interest rates rise at some point in the quarter. Given the current steepness in the yield curve, PFM recommends using a "barbell" strategy whereby the County would maintain a high balance in money market funds and purchase 2 – 3 year Agency securities. The longer-term securities will provide additional yield and allow the County to benefit from the steep yield curve.
- **Maintain allocation to callables.** As of September 30, 2001, 13% of the County's portfolio remained invested in callable Federal Agency securities. This is well within PFM's recommended maximum of 20-25% allocation in callable securities. Recent purchases of callable securities were purchased with several months of call protection. None of the current holdings are subject to call until February 2002.

The sector and maturity composition recommendations below are based on our current market assessment, the County's investment objectives and limitations imposed by the County's investment policy.

Investment Sector	Recommended Average Maturity	Current Average Maturity	Recommended % of Portfolio	Current % of Portfolio
U.S. Treasury Obligations	9 months - 1.0 years	8.3 Months	5% - 15%	5%
Federal Agency Notes/Discount Notes	6 months - 2.0 years	1.19 Years	50% - 75%	63%
Municipal Obligations	6 months - 2.0 years	0.75 Years	0% - 5%	1%
Commerical Paper, Certificates of Deposit, Domestic Banker's Acceptances, State Pool	1 - 60 days	18 Days	20% - 40%	31%
Aggregate Average Maturity	9 - 10 months	9.8 Months		

